

REPORT OF EXAMINATION  
OF THE  
PACIFIC UNION ASSURANCE COMPANY  
  
AS OF  
DECEMBER 31, 2004

Participating State  
and Zone:

California

Filed: March 3, 2006

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San Francisco, California  
November 15, 2005

Honorable Alfred W. Gross  
Chairman of the NAIC Financial  
Condition Subcommittee  
Commissioner of Insurance  
Virginia Bureau of Insurance  
Richmond, Virginia

Honorable John Morrison  
Secretary, Zone IV-Western  
Commissioner of Insurance and Securities  
Montana Department of Insurance  
Helena, Montana

Honorable John Garamendi  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Chairman and Commissioners:

Pursuant to your instructions, an examination was made of the

**PACIFIC UNION ASSURANCE COMPANY**

(hereinafter also referred to as the Company) at its main administrative office located at 2727-A Allen Parkway, Houston, Texas 77019. The Company's statutory home office is located at Two Rincon Center, 121 Spear Street, San Francisco, California 94105.

**SCOPE OF EXAMINATION**

The previous examination of the Company was made as of December 31, 2001. This examination covers the period from January 1, 2002 through December 31, 2004. The present examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions, an evaluation of assets, and a determination of liabilities as of December 31, 2004, as deemed necessary under the circumstances.

This examination was conducted by the California Department of Insurance pursuant to the National Association of Insurance Commissioners' plan of examination. In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; and sales and advertising.

### SUBSEQUENT EVENTS

From December 31, 2004 to March 31, 2005, the Company has reported an unrealized capital loss of \$13.9 million for the investment in its parent company's stock, American International Group, Inc. (AIG). While the loss is material, the Company remains financially solvent.

The loss occurred with the disclosure of the federal and state regulators' investigations into AIG's financial accounting of reinsurance and other transactions and the delayed reporting of AIG's 2004 financial statements. AIG released its 2004 10K report along with restated financials from 2000 to 2003, on May 31, 2005. Since the release of the 2004 financial statements, the stock value of AIG has improved.

During the second quarter of 2005, A. M. Best changed its rating of the Company from A+ to A-.

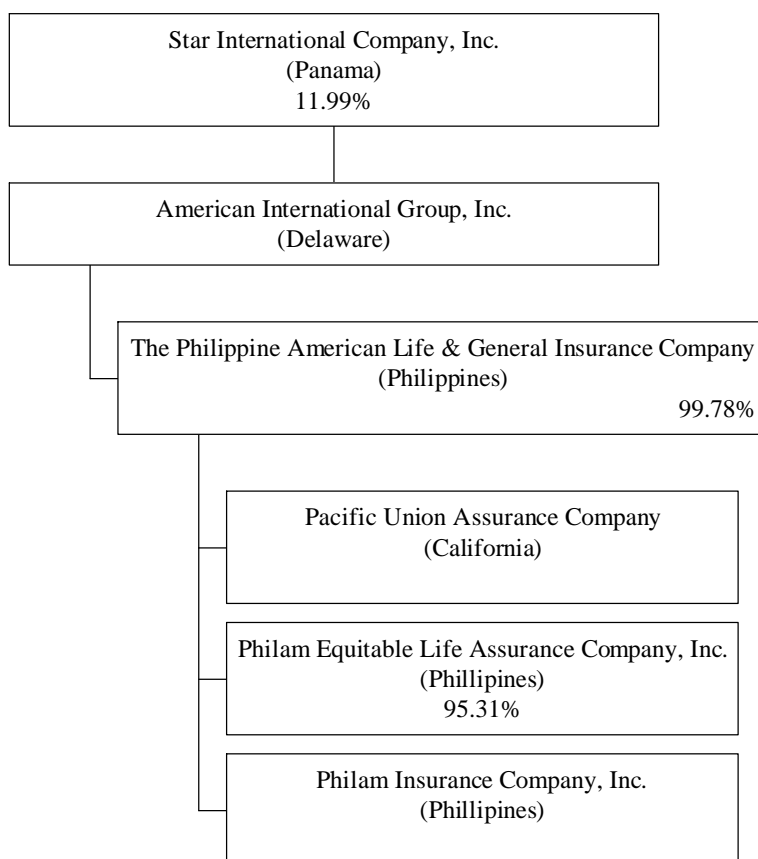
### COMPANY HISTORY

The Company is organized under the laws of the State of California. It was incorporated on June 22, 1972 and commenced business July 1, 1973. The Company is authorized to write life and disability insurance in California and Hawaii. In April 2005, the Company restated its bylaws. The restated bylaws were filed with the Department in May 2005.

## MANAGEMENT AND CONTROL

The Company is a wholly-owned subsidiary of The Philippine American Life and General Insurance Company, Philippines, which, in turn, is a 99.78% owned subsidiary of American International Group, Inc. (AIG). AIG maintains control of the Company through indirect ownership of all of the Company's voting securities. The ultimate controlling entity is Starr International Company, Inc. (SICO). Ever since April 2002, the Company has reported that SICO disclaimed control over American International Group, Inc. in its yearly Annual Holding Company Registration Statement filings. The affiliation disclaimer by SICO and C.V. Starr and Company filed by the Company in January 2001 was denied by the California Department of Insurance in February 2001.

The following abridged organizational chart depicts the interrelationship of the companies within the holding company system (all ownership is 100% unless otherwise indicated).



Management of the Company is vested in a board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2004 follows:

#### Directors

<u>Name and Residence</u>	<u>Principle Business Affiliation</u>
Merton B. Aidinoff New York, New York	Retired Partner Sullivan & Cromwell
David L. Herzog St. Albion, Missouri	Vice President – Life Insurance American International Group, Inc
Donald P. Kanak, Jr. Hong Kong, China	Executive Vice Chairman and Chief Operating Officer American International Group, Inc
Rodney O. Martin, Jr Houston, Texas	Executive Vice President - Life Insurance American International Group, Inc
Ernest T. Patrikis New York, New York	Senior Vice President and General Counsel American International Group, Inc
Gary D. Reddick The Woodlands, Texas	Executive Vice President and Chief Administrative Officer American General Life Companies LLC
Martin J. Sullivan Chappaqua, New York	President and Chief Executive Officer American International Group, Inc
Christopher J. Swift Houston, Texas	Chief Operating Officer and Chief Financial Officer American General Life Companies, LLC

#### Principal Officers

<u>Name</u>	<u>Title</u>
Rodney O. Martin, Jr.	Chairman of the Board, President and Chief Executive Officer

<u>Name</u>	<u>Title</u>
Gary D. Reddick	Executive Vice President and Chief Administrative Officer
Christopher J. Swift	Executive Vice President and Chief Financial Officer
Robert F. Herbert, Jr.	Senior Vice President, Treasurer and Controller
Robert M. Beuerlein	Senior Vice President and Chief Actuary
Paul L. Mistretta	Executive Vice President
Elizabeth Margaret Tuck	Secretary

In addition to the above officers, the Company has 12 Vice Presidents.

#### Management Agreements

Investment Advisory Agreement: Effective April 1, 1999, the Company entered into an Investment Advisory Agreement with AIG Global Investment Corp. whereby the latter serves as investment manager subject to directions approved by the Company's board of directors. The service fee is based on the average market value of the Company's investments. This agreement was approved by the California Department of Insurance (CDI) in March 2003.

Administrative Services Agreement: Effective December 1, 2002, the Company entered into an Administrative Services Agreement by and between the Company and AIG Business Processing Services, Inc. (BPS). The agreement allows a 10% mark-up fee for Philippine government mandated charges. This agreement was approved by the CDI in December 2002 with the stipulation that the Company file another application if the mark-up charges rise to 20% or more.

Ordinary Life Administration Agreement: Effective January 1, 2002, the Company entered into an Affiliated Company Agreement with its domestic life affiliates. The purpose of the agreement was to treat all the companies as a single entity for the purposes of participation in an administration agreement with Special Pooled Risk Administrators for the pooling of the loss claims between the Company and its affiliates. Effective July 1, 2002, the participants of the Affiliated Company Agreement entered into an Ordinary Life Administration Agreement with Special Pooled Risk

Administrators, Inc. a non affiliate, as administrator. These agreements were approved by the CDI in September 2002. The Affiliated Company agreement was terminated effective July 1, 2003.

Service and Expense Agreement: Effective June 9, 1981, the Company entered into an amended 1974 Service and Expense Agreement with AIG, Inc. and some of its subsidiaries. As of December 31, 2003, there were 31 addendums to this agreement. Addendums 26 through 33, which entered additional parties to the Service and Expense agreement, were added to the agreement during the examination period.

### TERRITORY AND PLAN OF OPERATION

The Company is authorized to write life and disability insurance in California and Hawaii. In 2004, the Company wrote \$308,666 of direct premiums. Of the direct premiums written, \$138,399 (44.8%) were written in California, \$161,949 (52.5%) were written in Hawaii and \$8,318 (2.7%) were waived or written in the remaining states. Effective May 2004, the Company withdrew its license to write in the State of Oregon.

The Company has not written any new business since 1984. The only source of business is renewals.

### REINSURANCE

#### Assumed

The Company does not have reinsurance assumed business.

#### Ceded

In 2004, the Company participated in a Catastrophic Reinsurance Treaty with its parent, American International Group. A review of the reinsurance agreement, which became effective January 1, 2004, disclosed the termination provision and the insolvency clause were not in compliance with



California Insurance Code (CIC) 922.2. The termination provision allows the reinsurer to terminate the agreement if the reinsured should become insolvent and is also the controlling provision in the event of conflict with any other provision. This provision does not provide for payments to be made without diminution because of the insolvency of the ceded reinsurer. The insolvency clause states the reinsurance shall be payable directly to the Company, but the reinsurance or risk assumed to be paid is not defined in the contract. The clause does not provide, in substance, indemnification for the portion of risk it has assumed. Upon treaty renewal, these articles must be amended to comply with CIC Section 922.2(a) in order for the Company to receive reinsurance credit in its future financial statements.

As previously noted, the Company has not written any new business since 1984. Most of the reinsurance contracts still in force do not provide for the cession of new business, only renewal. Reinsurance is ceded on a yearly renewable term and coinsurance basis, mostly under pooling arrangements. Generally, the Company's maximum retention ranges between \$25,000 and \$100,000 per individual life.

### FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2004

Summary of Operations and Capital and Surplus Account  
for the Year Ended December 31, 2004

Reconciliation of Capital and Surplus from December 31, 2001  
through December 31, 2004

Statement of Financial Condition  
as of December 31, 2004

<u>Assets</u>	<u>Ledge and Nonledger Assets</u>	<u>Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 21,276,543	\$ 21,276,543	(1)
Stocks: Preferred	6,237	6,237	
Common	88,781,016	88,781,016	
Contract loans	1,343,431	1,343,431	
Cash and short-term investments	524,261	524,261	
Investment income due and accrued	371,340	371,340	
Reinsurance ceded: Other amounts recoverable from reinsurers	160	160	
Uncollected premiums and agents' balances in course of collection	8,921	8,921	
Receivables from parent, subsidiaries and affiliates	<u>20,377</u>	<u>20,377</u>	
Total assets	<u>\$112,332,286</u>	<u>\$112,332,286</u>	
<u>Liabilities, Capital and Surplus</u>			
Aggregate reserve for life contracts		\$ 6,357,146	(2)
Liability for deposit-type contracts		280,496	
Contract claims: Life		66,054	
Policyholders' dividends		3,188	
Dividends apportioned for payment to December 31, 2005		17,534	
Premiums and annuity considerations received in advance		7,170	
Contract liabilities not included elsewhere:			
Other amounts payable on reinsurance ceded		22	
Interest maintenance reserve		112,625	
General expenses due or accrued		3,190	
Taxes, licenses and fees due or accrue		899	
Current federal and foreign income taxes		37,703	
Net deferred tax liability		30,563,284	
Unearned investment income		5,606	
Amounts withheld or retained by company as agent		679	
Amounts held for agents' account		27,453	
Remittances and items not allocated		71,750	
Miscellaneous liabilities: Asset valuation reserve		11,007,772	
Payable to parent, subsidiaries and affiliates (miscellaneous liabilities)		77,764	
Drafts outstanding (miscellaneous liabilities)		<u>19,790</u>	
Total liabilities		48,660,125	
Common capital stock	\$ 2,500,629		
Unassigned surplus	<u>61,171,532</u>		
Capital and surplus		<u>63,672,161</u>	
Total liabilities, capital and surplus		<u>\$112,332,286</u>	

Summary of Operations and Capital and Surplus Account  
for the Year Ended December 31, 2004

Statement of Income

Premiums and annuity considerations	\$ 272,263	
Net investment income	1,551,766	
Amortization of interest maintenance reserve	44,046	
Commissions and expense allowances on reinsurance ceded	3,014	
Reserve adjustments on reinsurance ceded	<u>(1,866)</u>	
Total		\$ 1,869,223
Death benefits	219,676	
Matured endowments	16,789	
Disability benefits and benefits under accident and health policies	3,626	
Surrender benefits and withdrawals for life contracts	259,433	
Interest and adjustments on policy or deposit-type contract funds	17,390	
Increase in aggregate reserves for life and accident and health policies and contracts	(167,420)	
Commissions on premiums and annuity considerations	4,982	
General insurance expenses	534,924	
Insurance taxes, licenses and fees, excluding federal income taxes	26,083	
Increase in loading on deferred and uncollected premiums	267	
Aggregate write-ins for deductions: Fines and penalties	<u>109</u>	
Total		<u>915,859</u>
Net gain from operations before dividends to policyholders and federal income taxes		953,364
Dividends to policyholders		16,243
Net realized capital gains		12,178
Federal income taxes incurred		<u>143,883</u>
Net income		<u>\$ 805,416</u>

Capital and Surplus Account

Capital and surplus, December 31, 2003	<u>\$63,085,443</u>
Net income	805,416
Change in net unrealized capital losses	(497,212)
Change in net deferred income tax	(17,739)
Change in liability for reinsurance in unauthorized companies	6,569
Change in asset valuation reserve	<u>289,684</u>
Net change in capital and surplus for the year	<u>586,718</u>
Capital and surplus, December 31, 2004	<u>\$63,672,161</u>

Reconciliation of Capital and Surplus  
from December 31, 2001 through December 31, 2004

Capital and surplus, December 31, 2001 per Examination			\$65,517,709
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 2,558,236	\$	
Change in net deferred income tax		25,258	
Change in net unrealized capital losses		12,060,121	
Change in nonadmitted assets and related items	3		
Change in liability for reinsurance in authorized companies	5,898		
Change in asset valuation reserve	<u>7,675,694</u>		
Total gains and losses in surplus	<u>\$10,239,831</u>	<u>\$12,085,379</u>	
Decrease in capital and surplus			<u>(1,845,548)</u>
Capital and surplus, December 31, 2004, per Examination			<u>\$63,672,161</u>

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Bonds

The custodial agreement with Mellon Trust of California, effective December 29, 2000, was not submitted to the California Department of Insurance (CDI) pursuant to California Insurance Code (CIC) Section 1104.9(d). The Company submitted the custodial agreement to the CDI for approval on October 10, 2005 and the agreement was approved on November 15, 2005.

### (2) Aggregate Reserve for Life Policies and Contracts

This liability account was tested, to the extent deemed necessary and determined to be reasonably stated.

A sample of 25 policy reserves was randomly selected from Excel file containing those contracts valued on “LifeComm Factors” basis, to validate the reserve data to policy files and/or related records. There were no material exceptions noted.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

Reinsurance Ceded (Page 6): A review of the reinsurance agreement disclosed the termination provision and the insolvency clause were not in compliance with California Insurance Code (CIC) Section 922.2. It is recommended that the Company amend the articles to comply with CIC Section 922.2(a).

### Previous Report of Examination

Management and Control (Page 5): It was recommended that the Company take the necessary steps to correct the discrepancies in the jurat page of the Annual Statements in the future. It was noted that the Company did not submit the investment advisory agreement with AIG Global Investment Corp. to the California Department of Insurance for approval in violation of CIC Section 1215.5 (b)(4). It was recommended that the Company comply with CIC Section 1215.5 (b)(4). The Company has complied with these recommendations.

Corporate Records (Page 6): It was recommended that the Company inform the Board that the Report of Examination has been received and is available for inspection and that the Company enter such facts in the board minutes pursuant to CIC Section 735. The Company complied with this recommendation.

Common Stocks (Page 11): It was recommended that the Company submit subsidiary information to the NAIC Securities Valuation Office for their calculation of the subsidiary's market value in compliance with SSAP No. 46, 7a. The Company complied with this recommendation.

Cash on Deposit (Page 11): It was recommended that the three bank accounts maintained outside California be transferred to, and maintained in California in compliance with CIC Section 1104.1. The Company has not complied with this recommendation. However, based on the immaterial balance of the accounts, the balance reported by the Company was accepted for the purposes of this Report of Examination.

## ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/S/

Sandra K. Bailey CFE  
Examiner-In-Charge  
Senior Insurance Examiner  
Department of Insurance  
State of California